

required justification for cable ownership concentration limits: namely, an alleged need to protect programmers from cable market power in order to ensure the efficient production and distribution of video programming to consumers.

88. Moreover, imposing a structural limit to facilitate benchmarking makes little economic sense. First, because of the growing competitive threat from DBS and other alternative MVPDs, franchised cable systems have private incentives to provide good customer service and signal quality independent of the franchise renewal process.⁵¹ Second, the argument also implicitly assumes that eliminating the cap will necessarily result in the loss of multiple MSOs that can serve as benchmarks. Although it is possible that there will be some increases in cable concentration if the subscriber limit were to be formally eliminated by the Commission, it does not follow that only a small handful of MSOs will necessarily remain in existence. Finally, the loss of sunk investment by MSOs that accompanies the loss of a franchise provides LFAs with ample bargaining power in negotiating the terms of renewal.

89. The *Notice* also asks whether a limit is justified because of theoretical concerns that a monopolist does not have the same incentive to innovative as a firm subject to competition. *Notice* ¶ 31 (citing Harvey Leibenstein, "Competition and X-Efficiency," *Journal of Political Economy*, May 1973, at 766). This theory has no applicability in this context. Any market power a cable company enjoys over consumers is geographically *local*. Thus, whether a cable MSO serves one, five, or twenty different geographic

⁵¹ In fact, incentives to provide high quality service are also enhanced by the MSO's desire to attract consumers to their telephony and internet services.

markets, in each of those local markets the MSO would have (according to this theory) the same lack of incentive to innovate (assuming *arguendo* that cable companies in fact have retail market power). Paradoxically, perhaps, if there are spill-over effects from the innovation process, a large MSO may be better able to internalize these externalities and may be more capable of recovering the fixed costs of research and development. The *Notice* also fails to acknowledge that there are many other sources of innovation that bear on the speed of technological progress in the MVPD “market.” In sum, this purported concern does not relate to the national size of a cable MSO (and like the “benchmarking” theory is also unrelated to the goal of protecting programmers from the exercise of cable market power).

90. Any concern that monopoly cable MSOs will “provide fewer choices among similar types of programming and charge higher prices for that programming than competitive MVPDs” fails to provide a justification for a national cable ownership limit for the same reasons. *Notice* ¶ 35. Even if legitimate, this concern would pertain only to a cable MSOs local market power over consumers and is irrelevant to a national cable ownership limit.⁵²
91. That leaves the vertical foreclosure theory. *See Notice* ¶ 29. Here the public policy issue is whether a cable MSO of a particular size has an incentive and ability to deny carriage to a programmer that competes with programming that the MSO itself owns thereby giving the MSO’s affiliated programmer the ability to charge supracompetitive rates to

⁵² The *Notice* also simply assumes without analysis of actual competitive conditions that the MSOs have market power vis-à-vis subscribers.

other MVPDs. Although this foreclosure theory at least links a cable MSO's national size with the ability to exercise market power *vis-a-vis* programmers, as explained in the next section, it does not, on the current record, provide a credible economic justification for structural limits on cable ownership concentration.

V. FORECLOSURE THEORIES DO NOT JUSTIFY A FIXED OWNERSHIP CONCENTRATION LIMIT.

92. As sketched out above, foreclosure is an exclusionary strategy designed either to enhance or protect the incumbent's extant market power or to "extend" its market power to other (non-coincident) markets. In the instant case, the apparent concern is that the MSO will disadvantage rival programmers in its cable systems and gain, as a result, incremental market power in the programming market to the detriment of other MSOs and ultimately consumers. Such an exclusionary strategy is, of course, costly. Denying carriage to rival programmers (or overpricing their services), decreases the overall value of the predator's own cable service offerings and thus causes it to lose subscribers, who either switch to retail rivals or decide not to purchase an MVPD service. Consequently, while an MSO, in principle, can deny carriage to a programmer (*i.e.*, has the ability to exclude), it may have no incentive to do so because the costs of the exclusionary strategy outweigh the possible gains. *See generally*, Thomas Krattenmaker & Steven Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 Yale L.J. 209 (1986).
93. At the outset, I note that the link between the foreclosure theory and the public policy limits on cable ownership concentration is less direct than it may appear. First of all, in the current context, the ability of a MSO to engage in foreclosure does not depend upon

its size. Plainly, any MSO – “big” or “small” – can refuse to carry a programming channel.⁵³ Consequently, the public policy concern has to be that a “large” MSO has stronger incentives to engage in an exclusionary strategy vis-à-vis programmers. However, such an inference cannot be drawn without more. Because, in the current context, foreclosure focuses on “vertical” links between programming and distribution, (*i.e.*, it is a “vertical” theory); the extent to which a cable MSO has incentive to implement such a vertical foreclosure strategy depends critically upon how much and what programming it owns. But a cable ownership concentration limit is a horizontal limit, totally decoupled from the MSO’s ownership interest in programming. MSOs that own little or no programming likely will have very different incentives to engage in such strategies as compared to the MSOs that are highly vertically integrated.⁵⁴ Moreover, the long-term trend of decreasing vertical integration in the industry, *see* Part III, suggests that foreclosure concerns (if any) may diminish over time thereby further belying the need for horizontal ownership limits to prospectively handle these concerns.

94. Further, in direct conflict with the premise behind a horizontal ownership limit, past a certain point the larger an MSO grows, the *less* incentive it has to undertake a foreclosure

⁵³ Indeed, a decision to refuse carriage by a large MSO (or DBS) is likely to be subject to more scrutiny than a decision by a “small” MSO. *See* Laura Holson, *EchoStar Is Ordered To Carry Disney Channels*, New York Times, at C3 (Jan. 1, 2002).

⁵⁴ This does not mean that even vertically integrated MSOs will have potent incentives to implement anticompetitive foreclosure strategies. It is important to recognize, however, that such integrated MSOs may have rational, efficiency-driven incentives to favor their own programming irrespective of the effect on rival programmers. *See, e.g.*, Janusz A. Ordover & Garth Saloner, *Predation, Monopolization, and Antitrust*, in 1 Handbook of Industrial Organization (eds. Richard Schmalensee and Robert Willig (1989)).

strategy. Although seemingly counterintuitive, this point is relatively simple. The larger the MSO, the greater are the losses suffered by foreclosing its systems to programs that consumers want to watch and replacing them with less desirable programming. Further, the larger the MSO, the lower are the gains from even a successful foreclosure. That is, because the goal of foreclosure is to gain power in the programming market that can be used against other MVPDs, the larger the foreclosing MSO, the fewer subscribers served by rival distributors and thus the lower are the revenues to be gained from exercising that power.

95. Indeed, in his accompanying declaration, Dr. Besen shows that any MSO whose subscriber base is large enough to engender the risks of anticompetitive foreclosure would have no incentive to implement it because the strategy would be unprofitable. As described above, the “gains” from foreclosure by a “large” MSO are likely to be relatively small because the size of the market that can be exploited following the execution of an effective foreclosure is “small.” Put another way, the larger the MSO, the smaller is the base of the remaining MSOs and other MVPD providers that can be potentially overcharged for the predator’s affiliated programming.
96. Thus, even if there were real foreclosure concerns vis-à-vis unaffiliated programmers, it is far from clear that limits on cable ownership concentration is the most effective public policy response to those concerns. That is particularly true given the availability of more targeted, direct regulation of the vertical anticompetitive conduct to be discouraged – *e.g.*, through enforcement of the Commission’s existing antidiscrimination rules or the application of the antitrust laws.

97. In reality, the concerns with vertical foreclosure by vertically integrated MSOs appear insubstantial.⁵⁵ This can be demonstrated using, for example, a well-established economic framework for assessing such risk and gauging the strength of the relevant incentives. *Accord*, DOJ Non-Horizontal Merger Guidelines §§ 4.24, 4.212, 4.213 (issued June 14, 1984) (“*Vertical Merger Guidelines*”).
98. As an initial matter, the MSO must control a sufficient percentage of *all* distribution channels to which video programmers could turn so that foreclosure would, in fact, significantly raise the programmers’ costs or prevent competitive entry of desirable programming content. *See* Krattenmaker & Salop, *supra* at 256-62. As explained below, this is necessarily a *dynamic* inquiry which requires an assessment not of the static “shares” of each of the available alternatives, but of their capacity and ability to win customers from cable operators that sacrifice quality to anticompetitive goals. A reasoned analysis must also recognize that programmers can use several counter-strategies to protect themselves from such exclusionary strategies.
99. In addition, the MSO must be able to gain power (that it did not have previously) over the price of programming. If the MSO does not gain power in the programming market, it has no ability to recoup the losses it suffers from undertaking a foreclosure strategy. *See* Ordover, Saloner, & Salop, *Equilibrium Vertical Foreclosure*, 80 Amer. Econ. Rev. 127-

⁵⁵ The fact that vertically integrated MSOs may in some instances favor affiliated content does not constitute the proof that such preferential treatment is a result of (and leads to) anticompetitive foreclosure. There are many efficiency-enhancing reasons for such treatment and the overall welfare effects of such preferential treatment may, in fact, be positive. *See, e.g.*, Tsaneem Chipty, *Vertical Integration, Market Foreclosure, and Consumer Welfare in the Cable Industry*, 91 Amer. Econ. Rev. 428 (2001) and the references therein.

42 (1990); Krattenmaker & Salop, *supra*, at 263-66. Thus, a reasoned analysis of the viability of a foreclosure strategy in this context must examine the competitive realities facing programmers, including barriers to entry into the provision of content and the minimum viable scale needed for profitable market presence.

A. Limits On The Ability To Foreclose: The Alternatives Available to Programmers.

100. Whether a cable MSO has the ability to foreclose depends primarily on two factors. First, what percentage of the relevant distribution outlets does the cable MSO itself control? Quite obviously, the lower the MSO's "share" of relevant distribution alternatives, the less ability the MSO has to put rival programmers out of business by refusing to carry them, or significantly impede them from entering the market. It is important in this context to recognize that *all* sources of distribution revenue open to programmers are relevant in assessing the ability of a particular cable MSO to induce exit or impede entry by means of foreclosure strategies. As I explain below, this means that the Commission must account for all the pertinent sources of revenues from content, including both non-U.S. MVPDs *and* non-MVPD alternatives such as broadcast TV.⁵⁶
101. Second, what are the alternatives *available* to the cable MSO's customers? As the Commission itself has recognized, even firms with very high market shares cannot exercise market power over their customers where there are competitive alternatives available with excess capacity and where customers have the ability and willingness to

⁵⁶ I have already shown in Part III that such alternatives are many and growing.

switch to those alternatives if they become dissatisfied with their current provider. *AT&T Non-Dominance Order*, 11 FCC Rcd. 3271 (1995).⁵⁷

102. The demonstrated ability of customers to switch from cable to DBS and alternative providers is very important here. If these other MVPD distributors can garner share from the foreclosing firm be virtue of offering superior programming (and attractive rates), then even being foreclosed from a large MSO does *not* mean that a foreclosed programmer will lose a significant share of the distribution needed to maintain competitive viability. This is because the ability of existing distributors (and new entrants) to expand their market share in the event of the degradation of service quality on the foreclosing MSO's systems – which is the first step in the foreclosure strategy – will (a) increase the costs of the strategy to the foreclosing firm and (b) lessen the impact of the foreclosure on the foreclosed firm. Hence, from the dynamic standpoint, it is necessary to examine the ability of rival distributors to “take up the slack” and to offer a viable competitive alternative(s) to the foreclosed programmer. Indeed, if the lost customer base on a particular system can be “recaptured” through other distribution channels, the competitive effects of the strategy will be muted or even non-existent.
103. The analysis of these two factors demonstrates that likelihood of anticompetitive foreclosure by even a large cable MSO to exercise foreclosure is quite remote.

⁵⁷ The Commission found that AT&T was “non-dominant” – *i.e.*, unable to exercise market power – in the domestic long distance market when AT&T had significantly more than half of all customers. As the Commission recognized there, the ability of other long distance providers to serve the demand and the ability and willingness of consumers to switch carriers rendered static markets shares largely meaningless.

104. *U.S. cable MSOs control only a portion of the distribution channels used by programmers.* As noted, from the standpoint of a programmer who potentially could be a victim of a foreclosure strategy, what matters is whether being removed from a given MSO renders it uncompetitive against the affiliated programming and whether being denied access to a given MSO makes it impossible for the programmer to garner enough revenues as to make the investment in content worthwhile. At the aggregate level, DBS, other non-cable MVPDs, and cable overbuilders account for nearly 20% of U.S. MVPD subscribers today and that DBS subscribership alone is expected to reach over 27 million by the end of 2006.⁵⁸ Even if one ignores how these shares would change in response to the exercise of foreclosure by a cable MSO, the current and expected number of subscribers served by DBS and other MVPDs is highly relevant to the ability of a major cable MSOs to foreclosure a new entrant. In particular, given that carriage agreements typically last several years, programmers that turn to DBS, other non-cable MVPDs and cable overbuilders benefit not just from their current, substantial subscription base, but will also earn additional revenues as these alternatives increase their subscription base over the length of the contract. A cable-programmer carriage agreement signed today would typically last until 2006, or even later, by which time DBS is expected to have over 27 million subscribers. Thus, even taking at face value the Commission's unsupported assumption that a programmer needs access to 15 million subscribers to be viable, and has roughly a 50 percent chance of reaching an agreement with any

⁵⁸ See *DBS Signals* at Table 4.

distributor, DBS alone can be expected to provide the requisite "open field" over the life of carriage agreements being negotiated today.⁵⁹

105. It must also be recognized that, for determining the incentive of a cable MSO to engage in foreclosure, the relevant distribution channels are broader than only U.S. MVPDs, as the Commission has implicitly assumed in the past. In order to assess properly whether a large cable company would have both the incentive and ability to abuse buyer market power, it is important to identify *all* the relevant market participants that can generate distribution revenues for the content supplier. Thus, the Commission must consider whether there are any geographic limitations on the sale of programming and the extent to which programmers can derive significant revenues by selling content to non-MVPDs.
106. I understand that there are no significant impediments to distributing programming internationally. The principal limitation on international distribution of U.S. programming instead is whether foreign consumers want to view it. While it may have once been the case that U.S. programming had only limited appeal overseas, that is no longer the case. As noted, video programming produced in the U.S. is increasingly sold in many foreign countries. *See* Part III. Programs that have broad international appeal

⁵⁹ Further, existing Commission regulation constrains the ability of cable MSOs to deny access to the share of the "market" that they control. As mentioned above, a programmer can obtain carriage without the cable company's cooperation either by making a carriage deal with broadcast or other networks that are guaranteed cable access through "must carry" regulations or by paying for access pursuant to the leased access regulations. Also, existing FCC regulations preclude a cable company from offering discriminatory carriage terms to rivals of its affiliated programming. Thus, the alternatives available to programmers in the face of foreclosure include not only DBS, but also some access to cable distribution, including, of course, to these MSOs that do not wish to subject themselves to supracompetitive prices that would hypothetically be charged by the foreclosing MSO for its affiliated programming.

generate both higher revenues for programmers and make the programmer less dependent on domestic distribution channels.

107. Likewise, the relevant set of distribution channels is broader than only MVPDs. A cable MSO's ability to foreclose rival programming is influenced by the availability of (and terms offered by) *all* potential purchasers of that programming, and not simply the terms that MVPDs offer aggregators that may purchase and resell the programming. That is because a seller's competitive disadvantage from being foreclosed by a large buyer turns, in large part, on the scope and revenue attractiveness of the distribution alternatives available to the seller.
108. The breadth and relative importance of the various alternative purchasers of video programming and sources of revenue depends critically on the *type* of content at issue. Unfortunately, that means an attempt to determine a precise "relevant" market for video programming is a complex analysis. For example, one could argue that, for some types of content, revenues derived from the sale of DVDs and videocassettes are a very important source of revenue, much more so than revenues derived from distribution over cable. This does not mean that the loss of cable revenues would be of absolutely no consequence to the movie studios. Far from it. However, the financial impact of foreclosure on movie studios and similarly developers of content could be qualitatively different as compared to the producers of dramatic television series, which are generally not widely distributed via DVD or videocassette.

109. That said, any economically sound ownership limit must reflect at least two significant non-MVPD distribution channels. For many content producers, broadcast TV is a feasible distribution channel (whether or not the viewer is or is not a cable subscriber). Indeed, to program developer, being able to reach the viewing public over the TV broadcast channel may be more attractive than being shown on a cable network. Although fewer in number than cable channels, broadcast TV attract a much larger audience. *Dual Network Order* ¶ 20 & n.46; *2000 Video Competition Report* ¶ 99. As a result, they generate much higher advertising revenues and thus may be better able to pay attractive fees to programmers.⁶⁰

110. Thus, although cable network packagers may require access to basic or premium cable, DBS and other MVPD distribution outlets to deliver the network to the viewers, program developers can also look to broadcast TV stations as attractive distribution venues. In principle, broadcast TV stations are available to the vast majority of consumers for “free,” but because of must-carry rules, these stations must be carried by cable companies. In fact, the Commission recognized that program developers view broadcast TV as an alternative to MVPD systems. In eliminating the “dual network” rule, the Commission recognized that the emergence of alternative video delivery systems had subjected the established broadcast networks to increasingly vigorous competition. *Dual Network Order* ¶ 36. Likewise, in the *2000 Video Competition Report*, the Commission

⁶⁰ Advertising revenue for the seven broadcast networks (ABC, CBS, Fox, NBC, PaxTV, UPN and WB) “alone reached \$18 billion in 1999”; “[i]n comparison” the over 200 cable programming networks “earned \$8.3 billion in advertising revenue.” *2000 Video Competition Report* ¶ 98.

concluded (§ 14) that “[b]roadcast networks and stations are competitors to MVPDs in the advertising and program acquisition markets.” Further, although broadcasters are today limited to only one channel, they will soon be able to multicast several channels using digital technology. *See supra* Part III.

111. “Premium” channels like HBO and Cinemax also clearly compete with VHS and DVD rentals and sales, with the latter being important sources of revenues, as already noted. More importantly, there are numerous premium movie channels that would be willing to carry any studio’s content, if the MSO were to try to exclude some studio from its affiliated premium movies channel.⁶¹ “We consider home video sales and rentals part of the video marketplace because they provide services similar to the premium and pay-per-view offerings of MVPDs.” *2000 Video Competition Report* § 114. Indeed, “[t]he video retail industry is the largest source of revenues for movie studios, generating approximately \$11.8 billion in 1999, three times the revenue received from theatrical distribution.” *Id.* § 116. Accordingly, even if a cable MSO had the ability to foreclose a particular video programming packager of such programs from its cable channel line up, or foreclose any particular content, such foreclosure likely would have little impact on whether the content that might otherwise be available on these cable networks would be produced and delivered to the viewing public. As such, it seems rather improbable that an MSO who is either integrated into the provision of premium movie channels or movie

⁶¹ Presumably, the strategy would be to refuse to bid for a particular studio’s movie product. It is difficult to imagine why such a strategy would make sense, given the competitive realities.

production could deploy an anticompetitive foreclosure strategy designed to lessen competition in the provision of movies to viewers.

112. In sum, the goal of this proceeding is to ensure continued availability of quality programming to distributors, and ultimately to the viewers. From a public policy perspective, the critical issue is whether consumers have an opportunity to view the programs that they would like to view and that prices for such programming broadly reflect the underlying costs.⁶² From the public policy perspective, there is no reason to ensure the profitability of entities that [package together such programs into “channels.” that produce the underlying content, or that distribute it to the viewers. Social welfare would only be harmed if foreclosure caused the number or quality of programs that are produced and distributed to consumers (by one means or another) to fall below the competitive equilibrium and resulted in elevated prices for the programming that is actually offered (thereby raising the costs of services that distribute these programs to consumers). Thus, the Commission should in its market power analysis account for *all* of the pertinent distribution channels that provide programmers with the ability to deliver their content to substantial numbers of viewers and to derive significant revenues from the distribution of such content.

113. *Any attempt by a cable MSO to degrade the quality of its programming in order to foreclose a rival would cause it to lose significant customers to DBS and other alternatives thereby undermining the effectiveness of its strategy.* Incentives to engage

⁶² These costs reflect, of course, the risks associated with investments in production of content, such as the fact that many products do not find consumer appeal.

in foreclosure are not related to static market shares held by the foreclosing MSO and its rivals. These incentives must take into account how the marketplace would respond if the MSO were to degrade the quality of its offerings by either removing an attractive offering or preventing an attractive offering from gaining carriage. The cost of such a decision may be low, if the cable subscribers have “nowhere to go.” But, in fact, they do. In this section I consider some of the evidence regarding the competitive constraint imposed on the MSOs by DBS and show that this constraint is very powerful. Because of the strength of this constraint, the incentives to degrade cable programming are significantly muted.

114. DBS competitors today have the ability to serve virtually all MVPD subscribers,⁶³ and the costs of switching from cable to DBS are now virtually non-existent.⁶⁴ Because of low switching costs and the attractive programming they offer, DBS providers are winning the lion’s share of new subscribers. *See 2000 Video Competition Report* ¶ 14 (showing 1.5% growth rate for cable and a 29% growth rate for DBS). Further, as noted,

⁶³ I am aware of no significant limit to the capacity of DBS providers to expand the number of customers they serve. DBS providers can expand output almost instantaneously because they already have invested in 100 percent national coverage, and, given that most costs are fixed, the marginal cost of serving additional subscribers is very low. It is true that some households may be unable to subscribe to a DBS service because of line-of-sight requirements in placing the receiving satellite antenna. However, this has no competitive relevance because even if an MSO could somehow identify customers that cannot receive DBS, the MSO could not deny quality programming to only those consumers that cannot switch to DBS. In this regard, I understand that both the Cable Act, 47 U.S.C. § 543(d), and many local franchise agreements and regulations require cable operators to have a rate structure for the provision of most cable services that is uniform throughout the geographic area in which cable service is provided. Consequently, a cable operator cannot escape the competitive constraints imposed by DBS by employing a strategy that segments its subscriber base.

⁶⁴ Consumers can now choose DBS without any up-front costs. DBS offers “free” equipment and installation in return for a term contract (typically, a year) or allows customers to lease equipment. *See DBS Signals* at 3.

most customers won by DBS are former cable customers. *See also* Complaint, *United States of America v. Primestar, Inc. et al.*, ¶ 63 (D.D.C. May 12, 1998) (“[M]ost DBS subscribers in recent years are former cable subscribers who either stopped buying cable or downgraded their cable service Cable and DBS compete by offering similar packages of basic and premium channels for a monthly subscription fee.”).

115. DBS operators likewise see themselves as competitors to cable. In fact, DirecTV and EchoStar have stated that they set their prices with “the objective . . . to gain market share by luring away consumers from the leading cable providers.” *See* Willig EchoStar-DirecTV Merger Dec. ¶ 11. According to the DBS operators, “the companies collect detailed data on cable pricing of many systems and, as necessary, adjust their pricing to remain competitive on a national basis.” *Id.*

116. Not only do cable and DBS compete on price, they also compete on quality. “DirecTV and EchoStar have been luring away cable’s most lucrative customers by offering more channels . . . and more movies and sports, greater pay-per-view (PPV) offerings.”⁶⁵ EchoStar continues “to utilize a ‘rifle’ approach aiming aggressive marketing campaigns at cable operators that have a material portion of their systems that have not been upgraded (or [that] EchoStar perceives [are] weak in their marketing effort).”⁶⁶ Perhaps the most vivid recent example of this principle was the DBS targeting of Time Warner

⁶⁵ *Communications Daily* (Aug. 28, 2000).

⁶⁶ Jeffrey Wlodarczak, CIBC World Markets, *The Cable/Satellite Battle Continues to Heat Up* at 1 (Oct. 8, 2001). CIBC predicts that “even with cable’s plethora of new services, consumers (especially in the current economic environment) are likely to be attracted by an increasingly rich EchoStar offer.” *Id.*

customers in New York when Time Warner and Disney reached impasse on carriage negotiations.⁶⁷

117. Recent empirical work confirms that consumers view DBS and cable as close substitutes and that any attempt at foreclosure would therefore be extremely costly to a cable MSO in terms of lost subscribers. For example, in the Commission's recent *Report on Cable Industry Prices*, 16 FCC Rcd. 4346 (2001), the Commission undertook a regression analysis of the effects of DBS on the demand for cable services and concluded that "DBS is a substitute for cable service." *Id.* ¶ 53.
118. Likewise, in a recent paper, Professors Goolsbee and Petrin collected data on the purchase decision of 15,000 households in 60 urban markets to estimate a system of demand curves for over-the-air TV, DBS, expanded basic cable services and expanded basic and premium cable services. Austan Goolsbee & Amil Petrin, *The Consumer Gains from Direct Broadcast Satellites and the Competition with Cable TV*, University of Chicago Graduate School of Business Working Paper (October 2001).⁶⁸ From their estimated elasticities and shares, one can compute diversion ratios, which is a measure of substitutability between goods. See Carl Shapiro, *Mergers with Differentiated Products*, 10 Antitrust 23-30 (Spring 1996).⁶⁹ Using the Goolsbee-Petrin data, the diversion ratio

⁶⁷ Chris Rohrs, *Electronic Media*, at 12 (May 15, 2000) ("It is clear to everybody that the Time Warner-Disney dispute gave a boost to the already growing satellite television industry."). Indeed, Disney even offered to subsidize consumers that switched to DBS. Diane Mermigas, *Electronic Media*, at 30 (May 8, 2000).

⁶⁸ I note that the results presented in this paper are preliminary and subject to change.

⁶⁹ If two goods are substitutes, then as the price of good one increases, its quantity sold decreases, and the quantity sold of good two increases. The diversion ratio (from good one to
(continued . . .)

from even *basic* cable to DBS is between 0.26 and 0.4, which means that 26-40 percent of basic cable customers who leave cable in response to an increase in cable prices would choose DBS instead. These diversion ratios are significant and imply that DBS and basic cable are close substitutes. Indeed, in residential long-distance service, diversion ratios from WorldCom to Sprint and from Sprint to WorldCom have been estimated to be .05 and .11, respectively and there is little debate that Sprint and WorldCom long distance services are close substitutes. *See* Declaration of Jerry Hausman, Table 1 (filed in CC Docket No 99-33 on Feb. 18, 2000).

119. Importantly, these inferences from the Goolsbee and Petrin econometric results likely underestimate the competitive interactions between cable and DBS. The data relied upon Professors Goolsbee and Petrin predate passage of the SHVIA, which eliminated the prohibition on DBS delivery of local network signals. As the Commission itself has recognized, the elimination of this restriction has significantly enhanced the competitiveness of DBS relative to cable. *2000 Video Competition Report* ¶¶ 68-71.¶
120. Even if one could demonstrate that there are some local markets in which cable MSOs would not lose a significant number of customers if it were to degrade its quality relative to the rival offerings, this would not resurrect the validity of public policy concerns with foreclosure. Indeed, if an MSO were to remove (or otherwise foreclose) a rival

(... continued)

good two), measures how much of the quantity lost by good one is gained by good two and equals $(e_{21} * q_2) / (e_{11} * q_1)$ where e_{ij} is the cross price elasticity of demand for good "i" with respect to the price of good "j."

programmer only from these cable systems where alternatives to the MSO's service are weak, the harm to the rival programmer would be significantly lessened. At the same time, the benefits to the cable MSO from foreclosure would be reduced, because the rival would continue to be present in all the other systems (as well on other distribution modes).

121. *Programmers' can employ counter-strategies that greatly diminish the ability of a cable MSO to foreclose* MSO's ability profitably to engage in an exclusionary strategy is further constrained by the ability of many programmers to retaliate against any cable MSO who attempts to engage in such conduct. See Krattenmaker & Salop, *supra*, at 269-75 (economic inquiry into effectiveness of foreclosure must consider rivals' counter-strategies). Most programmers own several different programming networks. See generally *2000 Video Competition Report*, ¶¶ 172-76, Table D-1. Even if an MSO were relatively indifferent whether it carried some of the target's networks, the target may hold exclusive rights to one or more very popular networks that, if not carried, would place an MSO at a significant competitive disadvantage relative to other MVPD, such as DBS. An MSO's decision to foreclose one of these programmers' "second tier" networks could thus evoke a retaliatory response that denies the MSO carriage of the programmer's entire package of programming, including the programmer's most popular networks. In fact, it is quite common for programmers to use this type of "bundling" to gain "bargaining power" as well as to lessen the competitive pressures on "weaker" offerings that face more ready substitutes. Of course, like foreclosure, such a countervailing strategy may be costly to the programmer (especially if it is forced to carry out its threat).

Nevertheless, the higher the potential harms from being foreclosed by an MSO the stronger is the countervailing incentive to impose costs on the MSO with the goal of reaching a mutually agreeable *modus vivendi*.

122. Relatedly, many of the programmers that could be targets of an exclusionary foreclosure, are themselves affiliated with other MSOs. See *2000 Video Competition Report*, App. D. If an MSO tried to foreclose a programmer affiliated with another MSO in order to gain market power in the programming “market”, the second MSO, who could end up paying elevated prices for programming, could in turn retaliate and refuse to carry the affiliated programming of the foreclosing MSO. The effect of the counterstrategy would be that the MSO implementing foreclosure could find its affiliated programming subject to an equal or greater amount of foreclosure.⁷⁰

B. The Implausibility Of Claims That Foreclosure Would Facilitate Significant Gains In The “Secondary” Programming Market.

123. A rigorous economic analysis must not only consider the concentration of the distribution alternatives available to programmers, the available capacity of other purchasers, and

⁷⁰ The *Notice*’s statement (§ 30) that an ownership limit might be necessary in order to prevent a large MSO from using its “leverage” to preclude the ability of new entrants to gain programming necessary to compete adds little to the analysis. This “barriers-to-entry” strategy is just one of the ways in which foreclosure market power could be manifested. The question of whether such market power exists, and at what level of concentration, is, of course, the critical issue in this proceeding and the one which I address. Further, rigid structural regulation would be a grossly overbroad solution to this perceived problem. Exclusive deals allow product differentiation that is often *pro*-competitive, and any such contracts would, of course, be subject to challenge under the antitrust laws if these contracts created cognizable competitive risks to existing or future competition in any relevant antitrust market. Moreover, I am not aware of any complaints that cable MSOs are obtaining exclusive national programming arrangements and that this is impeding the ability of DBS to compete. To the contrary, I understand that DBS has exclusive sports programming that is not available to cable MSOs.

their ability to win customers from cable operators that sacrifice quality to anticompetitive goals, but also barriers to entry into the programming market. As explained in the *Vertical Merger Guidelines*, there is broad agreement among economists that a foreclosure strategy cannot be successfully undertaken unless the “secondary market” has high entry barriers and is therefore susceptible to monopolization. *Vertical Merger Guidelines* § 4.212; see also Michael Riordan & Steven Salop, *Evaluating Vertical Mergers: A Post Chicago Approach*, 63 Antitrust L.J. 513, 532, 541 (1994); Alan Meese, *Antitrust Balancing in a (Near) Coasean World*, 95 Michigan L. Rev. 111, 146 (1996). The Courts too have recognized that even firms with high market share will be unable to exercise power where entry barriers are low. See, e.g., *Ball Memorial Hosp., Inc. v. Mutual Hosp. Ins. Co.*, 784 F.2d 1325, 1335 (7th Cir. 1986).

124. As foreclosure theories recognize, in order for foreclosure to be worthwhile, the profits resulting from exclusion must exceed the costs of exclusion plus the lost profits from foregone sales. See Jeffrey Church & Neil Grandal, *Systems Competition, Vertical Merger, and Foreclosure*, 9 J. Econ. & Mgmt. Strategy 25, 28 (2000); Riordan & Salop, *supra*, at 532. Barriers to entry into video programming, however, do not appear to be insurmountable. In fact, entry into the provision of video programming has been occurring at a rapid pace. For example, the Commission’s 2000 *Video Competition Report* identified (§ 175 & Table D-4) 66 new programming services that are being

planned. This strongly suggests that entry impediments are low, especially given the seemingly insatiable demand for new and attractive content.⁷¹

125. In the absence of barriers to entry any attempt to raise price in the secondary market will simply attract new competitors until the price drops back down to competitive levels.⁷² See DOJ/FTC, Horizontal Merger Guidelines, § 3 (revised April 8, 1997) (“*Horizontal Merger Guidelines*”); Richard Posner, *Antitrust Law: An Economic Perspective* 172-73 (1976). For example, assume that an MSO could foreclose a hypothetical “Environment Channel,” which offers nature-oriented programming, and cause its exit from the marketplace. If the MSO were then attempt to overprice its nature-oriented channel to other MSOs and DBS providers, the rival distributors could likely procure substitute nature-oriented programming within a relatively short time frame and thus escape the anticompetitive price hike. Simply stated, if foreclosure does not lead to a long-term exclusion (or substantial competitive weakening) of competitor, the incentive to engage in such behavior is diminished or totally obviated.
126. In this regard, a foreclosure strategy that disables only the “packager” of the content, but does not destroy the content itself, likely will have little competitive impact. The content

⁷¹ To be sure, there are possibly a handful of networks that offer a highly unique content and for which there may be no close substitutes. There may be high barriers to entry into the provision of this type of programming, as measured by the magnitude of sunk costs and a high minimum viable scale. However, these programs are also generally the ones that are considered to be “must carries” in the industry, and it is implausible that a cable MSO would attempt to foreclose one of these programs because doing so would be very costly to the bottom line of the MSO. Thus, I concentrate my analysis on those programs that could be more easily duplicated and that, at least in theory, could be potential targets of a foreclosure strategy.

⁷² This entry could either occur *de novo* or by another programmer already in the market.

provider(s) that formerly supplied the foreclosed program packager would have a strong incentive to reach terms with a new program packager to allow distribution of the content. And the terms of the deal could be quite favorable to the packager, given that the costs of already produced content would be sunk. Thus, a new entrant could reacquire the content that was used by the foreclosed program packager, but at a price that would be sufficient to allow it to earn a return on investment even should the foreclosing MSO continue to block access to its subscribers.

127. Finally, it will often be the case that inducing exit or lessening the competitive strength of just one rival programmer will not be enough to bestow market power on the affiliated programming. In order to garner such incremental market power and raise the price of affiliated programming (or to sell more programming), an MSO may need to foreclose many, if not all, of the programmers that compete with its affiliate. Given that there are currently over 280 national satellite-delivered video services, this could require the successful foreclosure of numerous programmers. *2000 Video Competition Report* ¶ 173 & Tables D-1, D-2. Again, given the strength of many of these video programmers (and their ability to use bundling), this seems highly unlikely. Distributors can also avoid the overcharge by simply refusing to carry the overpriced programming and substitute competitively provided programming, even if such programming may on the margin be less desirable to consumers. Thus, for example, if a nature-oriented programming becomes overpriced, an MSO may decide to substitute a cooking channel for the nature channel. If firms can avail themselves of substitutes for the overpriced input (such as particular programming) the incentive to engage in foreclosure is lessened or eliminated.

VI. A HORIZONTAL OWNERSHIP LIMIT IS LIKELY TO PRECLUDE SOME EFFICIENT CONSOLIDATION.

128. Any full-fledged economic analysis must also take into account public interest *benefits* of increased concentration. The *Notice* recognizes that the Commission should consider potential benefits of increased cable consolidation. If an unduly restrictive ownership limit is imposed, it could have a significant, negative impact on the public welfare, by foreclosing consolidation that would benefit the public. Congress recognized this, and in 47 U.S.C. § 533(f)(2)(D), it expressly directed the Commission “to take into account” the important efficiency benefits of cable expansions and territorial consolidations. Thus, even if there were a risk that cable ownership concentration would threaten video programmers in a competitively relevant way, the Commission would need to weigh that potential public interest harm against the public interest benefits of increased cable ownership concentration.
129. There are clear, identifiable public interest benefits to increased cable ownership concentration. First, economies of scale exist in administration and planning for new technologies and services. Larger MSOs are therefore likely to have lower per unit costs. Further, to the extent that cable ownership concentration could lead to lower costs of programming, consumers likely would benefit over the long haul through lower subscription fees. Such lower subscription fees could come about because competition among MVPDs creates incentives for passing to consumers a share of these lower programming costs.
130. Thus, an overly restrictive ownership limit could forestall possible rate reductions. Given that costs of programming have increased significantly over time, the Commission should

view favorably any possibilities for rate reductions (or at least for slowing down the increases in programming costs).

131. Relatedly, AT&T has presented considerable testimony in this proceeding showing that the costs incurred by a program service can be reduced by dealing with fewer cable systems. *See, e.g.,* Besen, Bernner, Woodbury, *An Economic Analysis of the FCC's Proposed Cable Ownership Restrictions* (filed Feb. 9, 1993). Fewer cable MSO purchasers means lower contracting costs. Likewise, there are lower costs of marketing when a single decision-maker can commit to taking a service for a large number of separate cable systems instead of the service having to obtain commitments from many separate cable operators.
132. Second, an overly strict ownership limit may undermine Congress' goal in Section 706 of the Telecommunications Act of 1996 ("1996 Act") to encourage widespread deployment of advanced telecommunications services to all consumers, as well as advanced digital cable services. The costs of upgrading facilities to provide digital cable service and advanced two-way services are enormous.⁷³ The Commission has recognized that firms can take advantage of scale economies by spreading development costs over a larger customer base are more likely to invest in infrastructure. Report, *Competition, Rate Deregulation, and the Commission's Policies Relating to the Provision of Cable Television Services*, 5 FCC Rcd. 4962, ¶ 71 (1990). But ownership limits necessarily

⁷³ *See* Robert Sachs (NCTA), *Prepared Testimony before Senate Committee re: Cable and Video: Competitive Choices* (April 4, 2001).

decrease the likelihood of mergers that will allow cable operators to achieve greater economies of scale.

133. Third, an ownership limit could require an MSO that is “too” successful at increasing its subscribership through superior marketing, customer service and provisioning of desired video programming to *divest* systems in order to remain under the subscriber ownership cap. *1999 Horizontal Ownership Order*, 14 FCC Rcd 19098, ¶¶ 24-25 (1999). Or, in the alternative, the horizontal cap could induce an MSO whose subscribership approaches the cap, to raise customer prices in order to choke off subscriber growth merely to avoid divesting some systems at a price reflecting the fact the MSO is forced to sell. Both of these logical responses to the cap are potentially harmful to consumer welfare. Cable MSOs that are more successful than their competitors at attracting customers should be encouraged to grow – and not given an artificial incentive to raise prices or divest systems in order to stay under the cap.
134. Finally, an overly strict limit can preclude cable MSOs from achieving the benefits “gained through increased ownership and control” of cable systems that are necessary for these companies to offer local telephone services in competition with incumbent LECs that already enjoy these economies. The local telephone markets are probably the largest remaining monopolies in the American economy. With over a hundred million captive consumers and many billions of dollars at stake annually, the lack of effective local telephone competition unquestionably harms the public.

135. The injury inflicted on consumers and the economy by incumbent LEC monopolists takes several forms. Most directly, the unavailability of competition for local telephone service forces consumers to pay higher prices for telephone service of lower quality (including fewer features and options) than a competitive market would offer. Incumbent LECs also extract billions of dollars annually from consumers by collecting “access charges” from long distance carriers that far exceed the cost of that “service.” And incumbent LECs have a powerful incentive to leverage their market power in voice telephony into next-generation technologies and advanced services.
136. The regulatory mechanisms for competitive entry into the local exchange markets enacted by Congress in the 1996 Act, however, have proven less effective than expected. There can be little argument that broad entry into local telephone markets through resale of services purchased at wholesale from the incumbent carriers has proven uneconomic. The wholesale discounts set by state regulatory commissions do not seem to allow new entrants to cover their own costs and earn a competitive return on investment, and because entrants’ costs remain tethered to incumbents’ prices, this form of competition can only drive down the implicit price of retailing services – while the bulk of telephony costs that are embedded in network services are immune to pressure from this type of competition. Although potentially more promising, the alternative of purchasing unbundled access to incumbent LEC networks has also been largely ineffective. Ultimately, new entrants are critically dependent upon the cooperation of the incumbent LECs that control the leased facilities. But the incumbent LECs have predictably – and effectively – resisted efforts to open up their networks.

137. For these reasons, at least in the near term, meaningful competition in the provision of local telephony services, including access, is likely to come primarily from companies that possess their own facilities. But there are enormous costs and risks associated with building such networks from scratch. Because they have existing networks in place, cable companies are among the most promising new entrants into the provision of local telephone services.

138. The entrenched incumbents that currently serve virtually all customers in concentrated and vast geographic areas still retain significant competitive advantages in this battle. Long experience in this industry has convinced us of the importance of the scale and clustering efficiencies in the provisioning of local services. By contrast, cable MSOs' footprints are geographically more diffuse and even AT&T, the largest cable MSO, serves significantly fewer customers than incumbent LECs such as SBC and Verizon. Thus, it is critically important not to impede unnecessarily the ability of cable MSOs to achieve the scale and scope necessary to allow them to compete effectively with incumbent LECs. But, as explained above, overly tight ownership rules have precisely that effect and could retard the ability of cable MSOs to achieve the necessary scale and scope efficiencies without any offsetting gain in reducing cable MSO market power.

VII. THE ALTERNATIVE APPROACHES IDENTIFIED IN THE *NOTICE* CANNOT BE USED TO SET LIMITS ON HORIZONTAL OWNERSHIP.

139. The *Notice* also seeks comment on a welter of other approaches to determining a proper limit on horizontal ownership. Most notably, the Commission asks whether it should revive the Open Field approach adopted in the 1999 *Horizontal Order* and struck down in

Time Warner. In addition, the Commission asks for comment on the use of the Implicit Lerner Index, the “q ratio,” and the use of HHI-based “safe harbors.” In my opinion, these approaches are either impractical in this context or fail to respond to the *Time Warner* Court’s holding that a horizontal limit must be based on a dynamic consideration of the range of distribution alternatives available to programmers.

A. The Open Field Approach.

140. Paragraph 58 of the *Notice* asks whether the Commission can fix the defects in its prior “Open Field” approach identified by the Court in the *Time Warner* decision. Under the Open Field approach, the Commission “assume[d] that a new programmer needs [20% of all MVPD] subscribers in order to have a reasonable chance to achieve economic viability.” *1999 Horizontal Ownership Order* ¶¶ 40-42. Second, the Commission found that, on average, penetration by programmers would be only 50% of available distribution channels and thus resolved to require an “open field” twice as large as the necessary minimum: 40% of all MVPD subscribers. *See id.* ¶¶ 47, 50. Third, the Commission assumed that the two largest MSOs would collude. *See id.* ¶¶ 43, 47, 51, 60.
141. The Commission should abandon the Open Field approach. As I explained above, sound economic analysis of monopsony and foreclosure risks requires a fact-intensive inquiry that may differ depending on the competitive concern (e.g., exercise of monopsony power or successful foreclosure). From this perspective, static market shares are woefully inadequate as a foundation for sound assessment of competitive concerns. In Parts III and IV, I already detailed various other empirical facts that are more pertinent than the market

shares. The Open Field approach relies on a series of analytical shortcuts that could lead to potentially incorrect public policy conclusions.

142. The Open Field approach is necessarily a static analysis. At bottom, it uses existing market shares as the yard stick for determining the ownership limit – *i.e.*, it assumes that programmers must have “access” to a fixed “share” of the MVPD “market” in order to be viable. As such, the Open Field approach does not heed the mandate of sound economics that the Commission account for the dynamic *availability* of alternative distribution channels, and for that reason alone it must be rejected.
143. The Open Field approach also necessitates a series of arbitrary and unsupportable simplifying assumptions. As noted, the first step in the Open Field analysis is to assume that a video programmer needs access to 20% of MVPD subscribers to be viable. I am aware of no empirical evidence that supports this 20% figure. Nor do I believe that such support could exist. It is simply illogical to believe that there is some single figure that can be applied across all types of programming content. The level of penetration needed for viability depends, for example, on both the cost of the programming and the willingness of subscribers to pay for it (either directly or indirectly via advertising). And the fact that DBS carries several programs that are not carried at all by cable operators conclusively rebuts the notion that carriage on cable systems is, in all cases, necessary for a programmer.
144. In fact, as set forth in AT&T’s comments, there are close to *50 national cable programming networks* that have been successfully launched and that remain in operation

today with *fewer than 15 million* MVPD subscribers. This group includes a number of well-known networks that were launched more than five years ago such as BET on Jazz; Discovery, Kids Channel; STARZ!, as well as more recently launched networks, such as Oxygen and National Geographic Channel. It is also notable that many networks, including some that are more than five years old, have less than 3 million subscribers.

145. The second assumption – that “a network has a 50 percent chance of obtaining subscribers on systems that are not actively denied to it,” *Notice* ¶ 52 – is likewise flawed. Again, I am aware of no support for this assumption. The assumption is also contrary to logic. A “disinterested” distributor cares only about the rate and the quality of programming. The worse is the “affiliated” programming and the higher is the rate charged for it, the more inclined will be the MVPD vendor to strike a deal with the allegedly foreclosed content provider. Also, as discussed above, a programmer that controls an extremely popular programming channel can attempt to bolster subscription rates for a less attractive channel by bundling that channel with its more popular channel(s). While such a strategy is not without costs, it may provide a needed launch pad for the new offering.

146. Also, whatever the merits of the “50% assumption” when it was first developed, it is critically undermined by recent increases in cable channel capacity, which diminish the relative importance of any MSO as a distribution outlet. As the Commission has recognized, increased channel capacity means that a programmer denied carriage by one MSO is much more likely to be able to obtain carriage by another MSO. *See Dual Network Rule Order* ¶ 12 (“the increase in channel capacity provides video programming

producers a greater opportunity to distribute their programming to consumers"). Accordingly, the assumption that a programmer will only have a 50:50 chance to gain carriage is unsubstantiated by the undisputed evidence of dramatic increases in cable channel capacity.

147. The third step – the assumption that two leading MSOs will collude – is also without basis in fact or in economics. Express collusion among MSOs designed to foreclose some programmer is, of course, subject to severe civil and criminal antitrust penalties that are generally thought to be adequate deterrence measures and there is no evidence that these measures would be inadequate in the markets under consideration here.⁷⁴ Thus, an evaluation of the likelihood of concerted action against programmers must assume that the MSOs will collude “tacitly” – *i.e.*, that firms will be able to coordinate their behavior vis-à-vis programmers simply by observing and anticipating their rivals’ market behavior rather than through express collusion. For example, a price leader may signal its “cartel” followers what programming to carry or how much to charge (or pay). However, such tacit collusion against programmers appears totally far fetched, given the nature of the relevant markets.

⁷⁴ I also note that in general, bid rigging and price fixing is primarily observed in two areas, government procurement and homogenous goods industries (*e.g.*, lysine and graphite electrodes). Unlike in most differentiated products industries where collusion is otherwise difficult to organize, bid rigging often occurs against the government because of the openness of the procurement process, the lack of incentive or ability of procurement agents to combat bid rigging, and the use of the government procurement process to further a social agenda that has nothing to do with purchasing goods at low cost. These factors, of course, are not present in the purchase of video programming.

148. First, as noted earlier, in the bargaining context, size is not necessarily an advantage. So, even if a “tacit joint bargaining cartel” could form, it does not necessarily follow that it could significantly (or at all) improve on the rates paid by the cartelists.
149. Most importantly, video programming contracts are private, long-term contracts for which prices are not published and therefore, unlike perhaps in other markets, an MSO may have no information on the prices paid by other MSOs. Hence, a favorable contract obtained by one MSO does not necessarily benefit any other MSOs. Indeed, a programmer can game the MSOs by offering favorable rates to an early adopter and then force the later MSOs to pay higher rates because these later subscribers may become more “pivotal” to the full recovery of the programming costs. Moreover, I understand that with respect to existing programming channels at least, contract terms tend to be staggered with different MSOs unlikely to be on the same contract cycle. Consequently, contract terms signed “today” may not be relevant for negotiations over contract terms “two weeks from today.”
150. In the same vein, it is difficult to imagine how the MSOs could tacitly agree on the rate that should be paid for programming. Surely, each MSO would like to argue that it cannot shoulder a very high rate, for whatever reason, and would want to free-ride on the payments made by others. It is well-known in economics that economic agents do not have proper incentives truthfully to reveal their willingness to pay for a public good. Indeed, it is hard to see how the possible free-rider incentives could be successfully resolved through tacit collusion. In any case, the *Notice* is silent on the critical mechanics of how the putative tacit bargaining cartel would operate. Consequently, the

concern that the MSOs would form and operate such tacit joint bargaining cartel is highly exaggerated and surely should not inform public policy towards rigid ownership caps.

151. An assumption that the MSOs would jointly engage in a foreclosure strategy is particularly far-fetched. As noted, expanding the number of "foreclosing" MSOs increases the costs of the exclusionary strategy and decreases the revenues that could be generated should the MSOs actually be successful in raising rival programmer's costs. Also, increasing the number of MSOs participating makes the strategy much more difficult to implement because no colluding MSO would agree to foreclose a programmer with which it is affiliated. And because, as we have seen implementation of the foreclosure strategy is costly, every MSO would rather have its compatriots bear the burden of the strategy while sharing in the potential benefits that may flow from it.
152. In all events, even if a tacit joint cartel is theoretically possible, there is no "safety in numbers" here that would overcome the central reason why a single large MSO could not credibly threaten to drop programming desired by customers. As described above, DBS and other competitors are waiting in the wings and willing and able at little cost to serve all cable customers. With this all too real competitive threat hanging over the putative "cartel's" collective head, it is difficult to imagine a group of cable MSOs agreeing not only that demanding anticompetitively low prices from video programmers is in their individual interests but also how far to push given the risk of losing customers to

competing providers. In short, even if cable ownership were highly concentrated, coordinated monopsony power would not likely be successful or long-lived.⁷⁵

153. The *Notice* apparently bases its concerns regarding collusion on a single article by John Kwoka that apparently stands for the proposition that “at least three competitors are necessary in most cases to produce competitive outcomes and reduce the possibility of collusion.” *Notice* ¶ 69 (citing John Kwoka, *The Effect of Market Share Distribution on Industry Performance*, 61 *Review of Economics and Statistics*, 101-09 (1979)). The notion that there is a “one-size-fits-every-industry” number of firms that is necessary to prevent collusion simply defies basic economics. As explained in the *Merger Guidelines*, there are a number of factors, which vary industry-by-industry, that influence the likelihood of coordinated interactions in a particular antitrust market. For example, “reaching terms of coordination may be limited or impeded by product heterogeneity or by firms having substantially incomplete information about the conditions and prospects of their rival’s business, perhaps because of important differences among their current business operations. In addition, reaching terms of coordination may be limited or impeded by firm heterogeneity . . . differences in vertical integration or production of another product that tends to be used together with the relevant product.” *Horizontal Merger Guidelines* § 2.11. Indeed, it is well recognized that even a tightly knit cartel

⁷⁵ Moreover, others have demonstrated that if monopsony power did exist, each cable system would be a monopsonist only with respect to programming supplied to its franchise area, and that combining franchise areas, if anything, helps internalize the effects of monopsony, resulting in less incentive to restrict quantity purchased. See Robert Crandall, *Economic Analysis of Market Structure in the Cable Television Business* at 10-11 (submitted by NCTA in FCC NOI Docket No. MM 89-600).

cannot exercise market power where barriers to entry are low because any attempt by the cartel to raise prices will simply attract new firms into the market, taking away sales from the cartel members. *Id.* § 3.0; *see also United States v. Baker Hughes, Inc.*, 908 F.2d 981, 989 (D.C. Cir. 1990) (“In the absence of significant barriers, a company probably cannot maintain supracompetitive pricing for any length of time.”).

154. I note that Dr. Kwoka’s analysis is one of many attempts by economists in the 1970s and 1980s to link the number of firms and/or concentration with market outcomes (*e.g.*, prices, margins). These efforts have been by and large unsuccessful.⁷⁶ First, it is hard to measure variables such as economic margins which are crucial for determining whether prices are elevated above pertinent costs. Second, concentration is endogenous and therefore any estimated correlation between concentration/number of firms and margins does not necessarily reflect a causal relationship. Finally, even if there were a causal relationship, it does not prove, without more, that high margins, for example, are caused by exercise of market power or by efficiencies.

155. Given the serious flaws associated with the Open Field approach, it should be abandoned as a guide to public policy in this area. If however, the Commission does decide to maintain the Open Field approach, a much higher limit appears to be warranted. For example, given that there is simply no realistic possibility that a “joint tacit cartel” aimed at squeezing programmers can form or persist, setting the limit at 60% still leaves an

⁷⁶ For surveys of the literature, *see, e.g.*, Richard Schmalensee, *Inter-Industry Studies of Structure and Performance*, and Timothy Bresnahan, *Empirical Studies of Industries with Market Power*, chs. 16 and 17 in 2 *Handbook of Industrial Organization* (1989).

Open Field of 40% available to a programmer, which, according to the FCC's own analysis, is sufficient to ensure the viability of all programmers.

B. The Commission Should Not Rely On The Lerner Index, The Q Ratio, or Static HHI Calculations To Set An Ownership Limit.

156. The *Notice* also seeks comment on use of the Implicit Lerner Index, the q ratio, or a static HHI calculation as useful indicia for gauging market power of the sort that is relevant to the public policy issues raised in this *Notice*. *Notice* ¶¶ 60-73. It is fair to say that these indicia have been applied in various antitrust and regulatory contexts (with appropriate caveats). However, the usefulness of these indicia is especially suspect when it comes to the issues of gauging monopsony power of foreclosure incentives.
157. The Implicit Lerner Index measures the difference between the price and the marginal cost. Cable companies, however, have substantial fixed costs while enjoying some economies of density. Thus, pricing their services to subscribers at marginal cost would not permit cable companies (or DBS vendors) a full competitive return on investment. As the Commission has recognized in the context of local telephone markets, in such circumstances the competitive equilibrium is that prices must exceed marginal cost and tend towards average "total service long run incremental cost." *Local Competition Order*, 11 FCC Rcd. 15499 ¶¶ 672-93 (1996).
158. Further, to the extent the *Notice* would seek to apply the Lerner Index to cable retail rates, such an application is meaningless because the critical issue is not whether cable MSOs have power over consumers (and should be rate regulated), but at what ownership level (if any) a cable MSO controls a sufficient percentage of all distribution channels that it

can exercise monopsony power or engage in profitable foreclosure. For such inquiries, the Lerner Index is not well-suited. An application of the Implicit Lerner Index to programming costs is also problematic, given the public goods nature of the product where rates are set through bargaining and where the issue is whether an MSO can somehow underpay its proper share of the total costs of the program.

159. The *Notice* itself recognizes that it is nearly impossible to apply the q ratio – which measures the ratio of the market value of the firm and the replacement cost of the firm’s physical assets. But even if this could be done, all that would it do is to show that some existing firms have some “market power.” This would provide no information, however, as to whether these firms have market power over programmers. To the contrary, because many cable MSOs have video programming interests (which are not necessarily traded as separate stocks), the q ratio might be positive because the firm has market power in video programming or in some other unrelated line of business.
160. Finally, the *Notice* asks whether “safe harbors” should be created using static HHIs. Although the HHI measure of market concentration is practical to implement, it is, like market share, simply a measure of current concentration and thus does not respond to *Time Warner*’s mandate to reflect the *availability* of non-cable programming distribution channels as a constraint on exercise of market power, as measured by elasticities of supply and demand. It is also important to recognize that the DOJ/FTC do not use the HHIs and changes in the HHI from a merger, as absolute caps, but only as presumptions that may be rebutted on the basis of the type of economic evidence discussed above.

VIII. THE SINGLE MAJORITY SHAREHOLDER RULE MAKES GOOD ECONOMIC SENSE BUT THE “SALE OF PROGRAMMING” ATTRIBUTION RULE SHOULD NOT BE REVIVED.

161. Lastly, the *Notice* seeks comment on whether the Commission should retain its single majority shareholder “exception” to attribution – which the Court in *Time Warner* reinstated after the Commission attempted to eliminate it – and whether the Commission should re-adopt the “sale of programming” attribution rule adopted in the context of determining whether the subscribers served by a partnership should be attributed to a limited partner – which the Court in *Time Warner* found unreasoned. See *Notice* ¶¶ 90, 97. Before discussing each of these attribution rules, it is important to discuss the purpose of attribution in this context. As former Commissioner Furchtgott-Roth stated, “without a clear sense of *why* to count, it is hard to know *how* to count.” *1999 Broadcast Attribution Order*, 14 FCC Rcd. 12559 (1999) (Commissioner Furchtgott-Roth dissenting). The reason *why* to count here is, assuming that there should be a cable ownership limit, to decide whether a cable system should be “attributed” to a stakeholder if it is reasonable to expect that the stakeholder’s economic interest likely will “create the type of economic incentives that the substantive cable rules are intended to address.” *1999 Cable Attribution Order*, 14 FCC Rcd 19014, ¶ 1 (1999). Thus, *how* systems should be counted is on the basis of control over the purchase of video programming. Where a cable company “is not materially involved in the video-programming activities [of another cable company], its investment does not extend its national programming power and the concerns of Section 613 are not implicated.” *Id.* ¶ 63.

A. The “Single Majority Shareholder” Exception Should Be Retained.

162. As the Commission has previously recognized, where a company is controlled by a single owner with more than 50% of the vote, it is not controlled by minority investors. As the FCC has explained: “In those instances where a corporate licensee, whether closely or widely-held, has a single majority shareholder, . . . the minority interest holders, even acting collaboratively, would be unable to direct the affairs or activities of the licensee on the basis of their shareholdings.” *1984 Broadcast Attribution Order*, 97 FCC.2d 997, ¶ 21 (1984). Thus, there can be no serious debate that, where there is a single majority shareholder, minority shareholders have no legal or economic ability to control programming decisions.
163. Nonetheless, the *Notice* hypothesizes some scenarios in which a cable system with a single majority owner would undertake programming decisions to benefit the minority shareholder. *See Notice* ¶¶ 88-90. It is important to note at the outset that, to be relevant for attribution, the goal is to identify economic interests that would cause a cable MSO to take programming actions that, in the absence of the *particular* minority ownership interest, it would not take. To the extent that a cable MSO has incentive to undertake certain programming decisions that might benefit the minority shareholder, there is no sense in which the minority shareholder should be counted as influencing programming decisions, if the same decision would have been made irrespective of the interests of the minority shareholder.
164. First, the *Notice* suggests that a minority investor may exert relevant influence over programming decisions because of the fiduciary obligations owed to minority

shareholders. *Id.* ¶ 90. Although not spelled out, the scenario the *Notice* seems to be contemplating is that the management of the cable MSO would seek to foreclose programming that competes with the programming of the minority shareholder. This makes no sense. Such actions would only harm the cable MSO by causing it to lose customers while any benefits would flow to the minority shareholder who would gain from the ability to increase the affiliated programmer's rates. Indeed, the foreclosing MSO could doubly lose because it would then become a potential victim of its own foreclosure actions. Certainly no fiduciary principles require management to take actions that harm the company and only benefit a minority stakeholder.

165. The *Notice* postulates even more subtle ways in which a minority owner might exercise influence over programming decisions. For example, it speculates that a large minority shareholder might withdraw its investment in the MSO in order to get the programming decisions it wants. *Id.* Again, such a threat is unlikely to create influence over programming decision. The minority party has already contributed the capital to the MSO and cannot just walk away with the assets of the MSO. All the minority party can do is sell its equity interest (by selling the stock), but that is generally something the MSO would be indifferent to because it does not share in the gains or losses of the sale of those securities. In any case, in the U.S. economy, there is no shortage of firms that can infuse capital into an MSO in the event that the minority shareholder decides to exit because the MSO is not willing to be subjected to abuse by the minority shareholder.
166. Similarly, the *Notice* observes that minority shareholders may have access to "confidential information." *Id.* I have, of course, no basis for evaluating the accuracy of

this assertion. But I see no way by which the fact that a minority shareholder might have access to confidential information by itself has any relevance to its ability to control management's decisions regarding programming purchasing. At most, this information sharing is relevant to facilitating collusion. But, as I have explained above, the ability of MSOs to collude successfully in the purchase of programming is extremely remote.

167. Finally, the *Notice* also speculates about some unquantifiable "special responsibility" that a management may feel to the minority shareholder. *Id.* But taking actions specifically to benefit the minority shareholder would breach management's fiduciary obligations to the company. And to the extent that management would have undertaken these actions regardless of the minority shareholder's identity and economic interest, the minority shareholder is not exercising control. In any case, where there is a special and empirically sound concern that a minority shareholder can exercise some undue influence on programming decisions to the detriment of programmers, that fact could be taken into account when a given transaction is examined by the competition agencies. I see no reason why these remote contingencies should be built into rigid formulas for calculations of "attributable" shares.

B. The Commission Should Not Revive The "Sale Of Programming" Attribution Rule Struck Down In *Time Warner*.

168. Limited partnerships are a common form of ownership in the cable industry. Importantly, limited partnerships are creatures of contract. "[P]artners in a limited partnership have the power, through contract, to determine their respective rights." 1999 *Cable Attribution Order* ¶ 61 (1999). Thus, the Commission correctly bases attribution

of limited partnership interests not on the size of the interest but on the presence or absence of recognized indicia of influence or control that “are designed to identify situations within which it is safe to presume that a limited partner will not be materially involved in the media management and operations of the partnership.” *Id.* This is the critical inquiry because if a limited partner does not control programming decisions, there is no way it could undertake the anticompetitive conduct against programmers that is the focus of this proceeding.

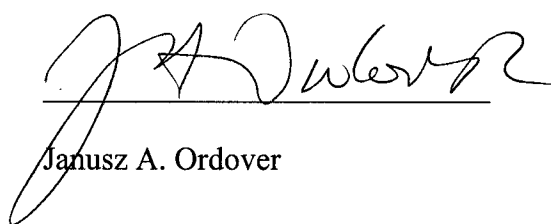
169. For the most part, these “insulation criteria” adopted by the FCC are reasonably tailored to the stated goal of ensuring that a limited partner “is not materially involved in the video-programming activities of [the] limited partnership.” *Id.* ¶ 63. Indeed, the criteria are very strict. A limited partner “may not communicate with the [limited partnership] or general partners on matters pertaining to the day-to-day operations of [limited partnership’s] video-programming business.” *Id.* ¶ 64 (listing insulation criteria).
170. Nonetheless, in its past order, the FCC required a limited partner to refrain from performing “any services for the partnership materially relating to its video-programming activities,” *id.* ¶ 64, which, the FCC held, encompasses any “affiliation agreement” between the limited partner and the limited partnership, *id.* ¶ 106. That is an industry term of art that refers to any “contractual arrangement to provide programming.” 1999 *Broadcast Attribution Order* ¶ 133. In other words, the FCC infers that a limited partner is “materially involved” in the limited partnership’s programming choices from the mere fact that the limited partnership has chosen to buy video programming owned by the limited partner, whether or not the limited partner played any role in the partnership’s

decision. *See also id.* ¶ 133 (“a contractual arrangement to provide programming would be inconsistent with the insulation criterion that ‘the limited partner may not perform any services for the partnership materially relating to its media activities’”).

171. There is no economic basis for such an inference or a rule and it should not be re-adopted here. The buyer-seller relationship simply does not materially involve the seller in the buyer’s decisionmaking process. Where a limited partnership chooses to fill one or more of its channels with video programming supplied by a limited partner that can legitimately certify (as it must to qualify for insulation) that it will not communicate with the partnership on day-to-day programming matters and that it has no recourse against a general partner that chooses the “wrong” programming, there is no rational basis for a categorical assumption that the limited partner is involved in programming decisions relevant to the purposes of the horizontal ownership limit. To the contrary, in these circumstances, the decision by the limited partnership to buy programming can be viewed as nothing more than an ordinary commercial transaction made because the programming purchased was, for the price paid, superior to other available commercial alternatives.

VERIFICATION

I, Janusz A. Ordover, declare under penalty of perjury that the foregoing is true and correct. Executed on January 2, 2002.



Janusz A. Ordover